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Highlights

Highlights of GAO-07-1014, a report to the Committee on Finance, U.S. Senate

July 2007

TAX GAP

A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance

Why GAO Did This Study

The Internal Revenue Service (IRS) estimates that $68 billion of the annual $345 billion gross tax gap for 2001 was due to sole proprietors, who own unincorporated businesses by themselves, underreporting their net income by 57 percent. A key reason for this underreporting is well known. Unlike wage and some investment income, sole proprietors' income is not subject to withholding and only a portion is subject to information reporting to IRS by third parties.

GAO was asked to (1) describe the nature and extent of sole proprietor noncompliance, (2) how IRS's enforcement programs address it, and (3) options for reducing it. GAO analyzed IRS's recent random sample study of reporting compliance by individual taxpayers, including sole proprietors.

What GAO Recommends

GAO recommends that the Secretary of the Treasury ensure that the tax gap strategy (1) covers sole proprietor compliance and is coordinated with broader tax gap reduction efforts and (2) includes specific proposals, such as the options in this report. GAO is not making recommendations regarding specific options. IRS and the Department of the Treasury provided technical comments on a draft of this report, which we incorporated as appropriate.

www.gao.gov/cgi-bin/getrpt?GAO-07-1014.

To view the full product, including the scope and methodology, click on the link above. For more information, contact James R. White at (202) 512-9110 or whitej@gao.gov.

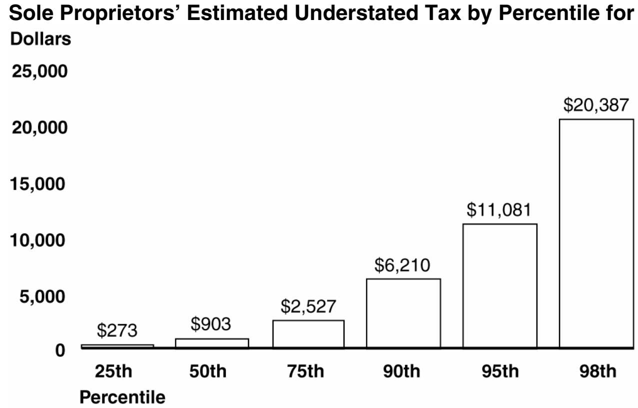
What GAO Found

Based on what IRS examiners could find, most sole proprietors, at least an estimated 61 percent, underreported net business income, but a small proportion of them accounted for the bulk of understated taxes. Both gross income and expenses were misreported. Most of the resulting understated taxes were in relatively small amounts. Half the understatements that IRS examiners could find were less than $903. However, 10 percent of the tax understatements, made by over 1 million sole proprietors, were above $6,200. In this top group, the mean understatement of tax was $18,000.

IRS's two main sole proprietor enforcement programs—the Automated Underreporter Program, which computer matches information on a tax return with information submitted to IRS by third parties, and examinations (audits)—have limited reach. The two programs each annually contact less than 3 percent of estimated noncompliant sole proprietors. The limited reach exists for a variety of reasons. In 2001, about 25 percent of sole proprietor gross income was reported on information returns by third parties; expenses generally are not subject to such reporting. Even when required, various barriers make information reporting inconvenient. Examinations of sole proprietors yield less in additional tax assessed and cost more to conduct than examinations for other taxpayers. However, because of the extent of sole proprietor noncompliance, any effect that examinations have on voluntary compliance by other sole proprietors could result in significant revenue.

The Treasury Department's recently released tax gap strategy discusses neither sole proprietor noncompliance specifically nor the many options that could address it. GAO has reported on the need for such a detailed strategy for years. Specific options that address issues including sole proprietor recordkeeping, underreporting of gross income, overreporting of expenses, information reporting, and IRS's enforcement programs are listed in appendix II.

Sole Proprietors' Estimated Understated Tax by Percentile for Tax Year 2001



Source: GAO analysis of IRS data.